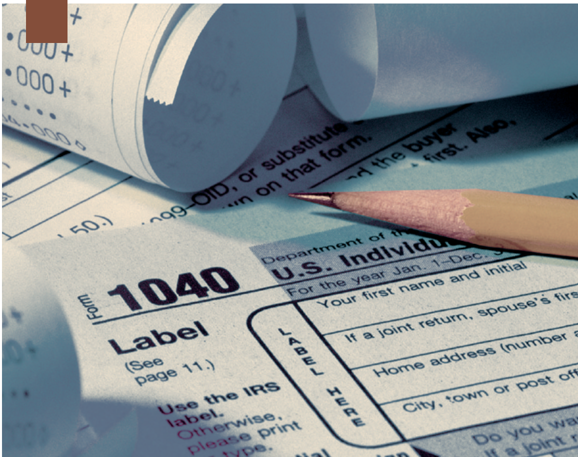

2007 Tax Planning Guide

Tax-saving tips to help minimize your tax liability.

This brochure highlights a number of significant federal tax changes brought about by recent pieces of legislation, prior law changes taking effect in 2007, and certain IRS regulations and procedures that will generally impact individuals and small businesses. These changes will ultimately affect just about everyone. Please contact us if you would like more information about these changes or need assistance in planning a strategy for your unique circumstances. Here is a rundown of some of the provisions:

- 2007 Inflation Adjustments
- Capital Gains & Dividend Rates Extended
- Charitable Contribution Rules Tightened
- Tax-Free IRA Distributions for Charity
- Congress Changes the "Kiddie" Tax Again!
- Plan Now For 2010 Roth Conversions
- Section 179 Expense Deduction
- Residential Energy-Efficient Credit Extended
- 2007 – Last Year for Home Energy-Savings Credits
- Spouses May Elect Out of Partnership Rules
- Big SUV Write-Offs May Soon End!
- Work Opportunity Tax Credit Extended
- Hardship Withdrawals Liberalized
- Medicare-B Premiums Increase Over Three Years
- Research and Development (R&D) Credit Extended
- 2007 – Last Year for Higher Education Expenses Deduction
- Sales Tax Deduction Slated to End in 2007
- Final Year for Teacher's Expenses
- Combat Pay EIC Election Lost After 2007
- One-Year Only Deduction – Mortgage Insurance Premiums
- New Refundable Minimum Tax Credit Provision

2007 Inflation Adjustments

Every year, many of the various tax limitations, deductions, allowances, etc., are inflation adjusted. The following are the more commonly-encountered values that apply to 2007:

- Personal and dependent exemption amount: $3,400
- Standard deduction: Joint filers – $10,700, Single – $5,350 and Head of household – $7,850
- IRA contribution limit: $4,000 ($5,000 if age 50 or over)
- IRA deduction phase-out AGI threshold: $52,000 for unmarried ($83,000 for joint filers)
- Spousal IRA deduction AGI phase-out threshold: $156,000
- 401(k) and 403(b) plan contribution limit: $15,500 ($20,500 if age 50 or over)
- Simple plan contribution limit: $10,500 ($13,000 if age 50 or over)
- SEP plan contribution limit: 25% (effectively 20%) of compensation or $45,000
- Business standard mileage rate: 48.5 cents per mile
- Moving and medical mileage rate: 20 cents per mile
- Maximum earnings subject to Social Security tax or self-employment tax: $97,500
- Annual gift tax exemption amount: $12,000

If you have questions regarding other limitations not listed here, please call.

Capital Gains & Dividends Bargain Extended Through 2010

Originally set to expire after 2008, the capital gains rates have been extended through 2010. In addition, the "zero" tax rates now apply to 2008 through 2010 instead of just 2008.

As part of a 2003 tax package, Congress reduced the preferential tax rates on capital gains from 10% and 20% to 5% and 15% respectively, with the lower rates applying to taxpayers in the 15% and under tax brackets. The 5% rate will drop to 0%, beginning in 2008. These lower rates apply to both the regular tax and alternative minimum tax (AMT).

Tax Bracket	Capital Gains Rates	
	2007	2008 – 2010
0 -15%	5%	0%
25% and Above	15%	15%

Capital gains rates apply to profits from the sale or exchange of capital assets held longer than one year or that have been inherited. Capital assets include corporate stocks, bonds, unimproved real property, rental property and taxable gain from the sale of a home. They don't apply to the portion of gain attributable to depreciation, which is generally taxed at a higher rate.

Zero Tax Rate Planning – With the long-term capital gains rates dropping to zero in 2008, and continuing through 2010, there is no tax on your long-term capital gains to the extent your regular tax rate is less than 25%. So depending on your situation, it may be appropriate to put off some of your sales that will result in gains until 2008. But before you make plans to sell everything in 2008 through 2010, remember the gain itself adds to your income, impacts income-based limitations, and possibly pushes you into a higher regular tax bracket, so it is a balancing act to take advantage of this zero rate. Of course, you can also use losses to offset the gains, and

contrary to conventional strategy, you should only have enough losses to keep the gain within the zero tax rate. Caution: Because Congress is concerned that taxpayers might transfer assets to their children to benefit from the zero tax rate, they raised the Kiddie tax threshold to include full-time students under age 24. See the Kiddie tax section included in this brochure.

Qualified Dividends Extended – The taxation of "qualified" dividends at long-term capital gains rates is also extended through 2010.

Charitable Contribution Rules Tightened

Although Congress has been active in the past few years enacting laws to curtail overstated and unverified contributions, the tax code still contains incentives to encourage contributions to approved charitable organizations. However, your tax deductions must be itemized in order to deduct charitable contributions, which means that there is no tax benefit gained if the standard deduction is taken.

Clothing and Household Items – Although there are stricter rules, the fair market value of used clothing and household items donated to a qualified charity can still be deducted, provided the items are in good or better condition, do not include items of minimal value and written documentation is obtained from the charitable organization verifying the contribution. Although severely curtailed, a vehicle may still be contributed to charity, but the deduction is limited to what the charity actually obtains from the sale of the vehicle if the claimed value is in excess of $500; IRS Form 1098-C (or equivalent substitute statement) must be attached to your return showing what the charity received for the vehicle. On the other hand, if the charity actually keeps and uses the vehicle in its charitable function, or sells it at a low price to a needy family, you may be able to deduct the fair market value of the vehicle.

Recordkeeping for Cash Donations – Beginning for the 2007 tax year, regardless of the amount of money contributed, the contribution must be backed up with either a bank record or written communication from the donee organization showing the: (1) name of the donee organization, (2) date of the contribution, and (3) amount of the contribution. The recordkeeping requirements may not be satisfied by maintaining other written records. What this means is that unless the charitable organization provides a written communication, cash donations put into a "Christmas kettle," church collection plate, and pass-the-hat collections at youth sporting events will not be deductible. Donations by checks and debit or credit cards can be substantiated by bank records.

Tax-Free IRA Distributions for Charitable Purposes

A provision expiring at the end of 2007 allows taxpayers age 70½ and older to have their IRA trustees make direct transfers of IRA funds (up to $100,000) to a qualified charity. The distribution is not treated as income on the donor's tax return, but no charitable deduction is taken for the transfer. The distribution to the charity counts toward the year's required minimum IRA distribution amount. At first glance, this does not seem all that big of a deal. However, for someone whose contributions allow them to marginally itemize – or who don't itemize – this can be a big benefit since their income (AGI) is lower without the IRA distribution. This may lead to reduced tax on Social Security income, marginal tax rates, capital gains rates and phase-out limitations, all leading to a lower tax for the year. Here is how a taxpayer can benefit from this new provision:

- By making a contribution directly from the IRA, a taxpayer is able to exclude the amount he or she contributed from his or her income for the year, which is essentially the same as deducting the contribution without itemizing deductions.
- This technique also lowers a taxpayer's adjusted gross income (AGI) for other tax breaks pegged at various AGI levels, such as medical expenses, passive losses, etc., allowing them greater benefits from the AGI limited deductions.

- For taxpayers receiving Social Security (SS), the taxability of the SS is also based on income. Thus, excluding the portion of the IRA distribution directly distributed to the charity can reduce the taxable portion of the SS.
- Taxpayers who wish to make very large contributions (up to the $100,000 limit) can do so with IRA funds that would have otherwise been taxable to them.

Example: *Retired couple (both over 70½) file a joint return. Their income consists primarily of required minimum distributions from their IRA accounts totaling $35,500, their SS benefits totaling $28,000, and $2,000 of investment income. They are very active with their church and make a $14,000 contribution each year. They have no other income or deductions. Compare the 2006 results with and without a qualified charitable distribution:*

IRA (RMD) Distributions	*$35,500*	*<14,000>*	*$21,500*
Taxable SS Incomes ($28,000 Total)	*12,375*		*2,750*
Investment Income	*2,000*		*2,000*
AGI	*49,875*		*26,250*
Church Contribution/Std Deduction	*<14,000>*		*<12,300>*
Personal Exemptions	*<6,600>*		*<6,600>*
Taxable Income	*$29,275*		*$7,350*
Tax	*$3,636*		*$ 735*

In this example, instead of making a charitable contribution, the taxpayer made a qualified charitable distribution of $14,000, lowering their AGI, reducing their taxable SS and then using the standard deduction. Result: Tax savings of $2,901.

Congress Changes the “Kiddie” Tax Again!

In the past couple of years, Congress has been tinkering with the Kiddie Tax rules. Beginning in 2006, they raised the age of children who are subject to the Kiddie Tax from under the age of 14 to under the age of 18. Now, another law change raises the age again, beginning with tax year 2008. The effect of these recent changes will be increased taxes for many middle-income and wealthy families who thought they were planning prudently for financing their children’s college education.

The purpose of the Kiddie Tax is to keep parents from placing investments in a child’s name to take advantage of the child’s lower tax rates. Thus, under the Kiddie Tax rules, a child’s investment (unearned) income in excess of an inflation-adjusted amount is taxed at the parent’s top tax rate, while the child’s earned income, such as wages, is taxed at the child’s own marginal tax rate.

To avoid the negative effects of the Kiddie Tax, it has been a popular higher-education funding tax strategy for parents to transfer appreciated capital assets, such as stock, to a child to be sold after the child was out from under the Kiddie Tax rules – initially age 14, then age 18 after the 2006 rules change. This strategy looked to be especially attractive for years 2008 through 2010 when the tax rate for long-term capital gains (and qualified dividends) drops to zero for taxpayers in the 15% or lower marginal rate. Parents of unmarried children, age 18 to 23, who are full-time students, expected that the children would also be able to enjoy the lower capital gains rates.

However, Congress has essentially closed this loophole by subjecting children through age 18 and full-time students, age 19 to 23, to the Kiddie Tax rules, beginning in 2008. Another change to the rules may prevent some of these older children from falling into the Kiddie Tax trap; if the child’s earned income exceeds one-half of the child’s support, the Kiddie Tax rules won’t apply. Support includes items such as clothing, education (but not scholarships), food, transportation and lodging. Because of these impending changes, a parent may want to reconsider any planned transfers of income-generating stocks, bonds, and other investments to children age 18, or those age 19-23 who are full-time students. However, placing or moving a child's funds into investments that

produce little or no current taxable income can help avoid the Kiddie Tax, at least in the years until the investments need to be sold or redeemed to pay for the education expenses. These investments include:

- **U.S savings bonds** – Interest can be deferred until the bonds are cashed.
- **Tax-deferred annuities** – Interest can be deferred until the annuity is surrendered.
- **Municipal bonds** – Generally produce tax-free interest income (may be taxable to the state).
- **Growth stocks** – Stocks that focus more on capital appreciation than current income.
- **Unimproved real estate** – That provides appreciation without current income.

If the family has a business, that family business could employ the child. The child's earned income is not subject to the Kiddie Tax and will generate a deduction for the family business (assuming the wages are reasonable for work actually performed). The child's earned income can offset the standard deduction for a dependent and the excess income will be taxed at the child's rate (not the parent's). In addition, the child would also qualify for an IRA, which provides additional income shelter.

Plan Now for 2010 Roth Conversions

Beginning in 2010, under the newly-enacted legislation, the income and marital status restrictions that limit the ability of a taxpayer to convert a traditional IRA to a Roth IRA have been removed, leading to some interesting and very advantageous tax and estate planning strategies.

Under prior law, an individual was allowed to convert a traditional IRA into a Roth IRA if the taxpayer's adjusted gross income (AGI) for the year (without the income from the converted IRA) was $100,000 or less. The $100,000 limit is figured without regard to required minimum distributions from an IRA. Although the income is taxable, the 10% early withdrawal penalty does not apply. Beginning in 2010, the new legislation:

(1) Eliminates the $100,000 modified AGI limit on conversions of traditional IRAs to Roth IRAs, and

(2) Permits married taxpayers filing a separate return to convert amounts in a traditional IRA into a Roth IRA. Under prior law, married taxpayers who filed separate returns were restricted from making conversions.

Special 2010 Income Inclusion Rule – For conversions made in 2010, the taxpayer can choose to elect to:

- Include the income in the 2010 return, or
- Include one-half of the conversion income in 2011 and one half in 2012.

Note: 2010 is the last year for the current "low" tax rates unless Congress extends them in future legislation. Income from conversions made in a year after 2010 will be taxable in the year of the conversion. There are also a number of special rules regarding early distributions with respect to conversions.

Looking Ahead – There are some interesting strategies a taxpayer can employ to convert nondeductible traditional IRA contributions to a Roth IRA, thereby funding the more favorable Roth IRA.

- ***Strategy*** – Taxpayers who have employer plans and are restricted from making deductible traditional IRA contributions because of income level can make nondeductible traditional IRA contributions in the three tax years leading up to 2010, and then convert those nondeductible traditional IRAs to Roth IRAs with virtually no tax since they were nondeductible. Only the earnings would be taxable. Taxpayers who are prohibited from making Roth IRA contributions because their income exceeds the limit may also benefit from this strategy.
- ***Strategy*** – Using the same strategy above, even a taxpayer who can make a deductible contribution can elect to make it nondeductible, providing the same result as above.

- ***Strategy*** – Generally, rollovers are thought of as transfers from a qualified plan to an IRA or from one IRA to another IRA. However, beginning in 2002, the law has allowed the taxable part of an IRA to be rolled (or transferred) to other qualified plans including 401(k) plans, 403(a) and 403(b) annuities and 457 governmental retirement plans (assuming the plan will accept the IRA funds). For taxpayers who have mixed IRAs (including both deductible and nondeductible contributions), this provides a means to segregating the taxable and nontaxable amounts and then later converting the nontaxable portion without paying any conversion tax (except on any interim earnings). Thus, the taxable portion can be rolled into a qualified plan, leaving the nontaxable portion in the IRA where it can be converted to the Roth IRA.
- ***Strategy*** – More aggressive taxpayers with the financial resources to pay the rollover tax might also consider rolling (or transferring) the funds from a qualified plan into a traditional IRA and then converting the traditional IRA to a Roth IRA.

Section 179 Expense Deduction Increases Extended and Enhanced

Legislation signed into law on May 25, 2007 increases the maximum amount that a taxpayer can deduct annually as a Sec. 179 expense from $100,000 to $125,000 for tax years beginning after 2006. It also increases the $400,000 phase-out threshold amount to $500,000 for tax years beginning after 2006. These amounts are inflation adjusted beginning in 2008 and before 2011. This allows taxpayers to continue to deduct the larger amounts for business assets through 2010. After 2010, the maximum deduction will revert back to $25,000.

The same legislation extended a taxpayer's ability to revoke a Sec. 179 expense election, and any specification contained in the election, for one additional year, to any tax year beginning before Jan. 1, 2011. It also extended the inclusion of off-the-shelf computer software in the definition of Code Sec. 179 property for one additional year through 2010.

Residential Energy-Efficient Property Credit Extended

The credit for the purchase of a residential energy-efficient property has been extended through 2008. This credit applies to the installation of solar and fuel cell equipment at the taxpayer’s residence, which may include a co-op or condo:

Solar water heater – For use in the taxpayer’s main home or second residence and at least half of the energy used is derived from the sun. The credit is 30% of the qualified property’s cost, limited to a maximum credit of $2,000.

Solar energy electric generating equipment – For use in the taxpayer’s main home or second residence. The credit is also 30% of cost, limited to $2,000.

Qualified fuel cell property – A fuel cell power plant that generates electricity by electrochemical means and has a 30% generation efficiency that is installed at the taxpayer’s primary residence. The credit is $500 for each 0.5 kilowatt of capacity with no maximum.

Cost includes installation as well as hardware costs, only applies to equipment installed in a home located in the U.S., and can't be used to heat a swimming pool or hot tub. Taxpayers receive no benefit from this credit to the extent that they are subject to the alternative minimum tax (AMT).

2007 – Last Year for Home Energy-Savings Credits

2007 is the last year that taxpayers can take advantage of the home energy-savings credits. The energy-savings credits are broken down into two categories:

Building envelope components – These include insulation material or system, exterior windows (including skylights), exterior doors, and metal roofs with appropriate pigmented coatings. These items qualify for a credit of 10% of their cost, subject to an overall lifetime maximum credit of $500, of which only $200 of the $500 limit can be from windows and skylights. The IRS has clarified that a building component that provides structural support or a finished surface, such as drywall or siding, does not qualify for the credit.

Qualified energy property – These items qualify for a 100% credit subject to the overall lifetime $500 credit limit and item limits noted below:

- Electric heat pump water heater, electric heat pump, geothermal heat pump, central air conditioner, and natural gas, propane, or oil water heater meeting specific standards. Only $300 of the cost is credit-eligible.
- A qualified natural gas, propane, or oil furnace or hot water boiler. Only $150 of the cost is credit-eligible; or
- An advanced main air-circulating fan. Only $50 of the cost is credit-eligible.

The credits are not phased out at higher-income levels, but are not deductible against the alternative minimum tax. Since the manufacturer will certify the materials that come with their products, the taxpayer does not have to determine whether a home improvement creates or saves energy.

Spouses May Elect Out of Partnership Rules

Included in the Small Business and Work Opportunity Act of 2007 is a provision that allows a husband and wife who file a joint return to elect out of the partnership rules. Thus, a joint venture between them is not treated as a partnership for tax purposes. This new rule takes effect for 2007.

All items of income, gain, loss, deduction and credit are divided between the spouses according to their respective interests in the venture, and each spouse takes into account his or her respective share of these items as if they were attributable to a trade or business conducted by the spouse as a sole proprietor. Thus, each electing spouse will report his or her shares on the appropriate form, such as Schedule C.

A qualified joint venture means any joint venture involving the conduct of a trade or business if:

(1) The only members of the joint venture are a husband and wife,

(2) Both spouses materially participate[1] in the trade or business, and

(3) Both spouses elect the application of this rule.

[1] Generally to qualify, 500 hours of participation are required during the year, or if participation is less than 500 hours, the taxpayers must provide substantially all of the participation.

Notwithstanding other self-employment rules, each spouse's share of income or loss from a qualified joint venture is taken into account under the above rules in determining the spouse's net earnings from self-employment. Thus, each spouse will receive credit for his or her self-employment tax contributions for purposes of receiving Social Security benefits. However, this rule is not intended to prevent allocations or reallocations, to the extent permitted under pre-2007 Small Business Act law, by courts or by the Social Security Administration of net earnings from self-employment for purposes of determining Social Security benefits of an individual.

Big SUV Write-Offs May Soon End!

If you have been thinking about purchasing an SUV for business to take advantage of the large tax break currently available, you better hurry. One of the provisions of the energy legislation currently under consideration by Congress would bring this big break to a screeching halt, by applying the same luxury auto rules to SUVs that apply to other passenger vehicles.

The Senate and House currently are considering energy legislation that contains a tax provision dealing with SUVs. If the SUV provision in the House version of this legislation becomes part of the final legislation, taxpayers who buy heavy sport utility vehicles (SUVs) after 2007 and use them for business will lose the generous Section 179 expensing and depreciation deductions that are available under current law.

Currently, heavy SUVs (those with a gross vehicle weight rating of more than 6,000 pounds) are exempt from the luxury auto deduction limits, because they fall outside of the definition of a passenger auto and thus were allowed to use the full Section 179 deduction without restriction. This provided taxpayers, in some cases, the ability to write-off the entire cost of the business portion of the SUV in the year purchased. In an earlier effort to curtail the tax breaks for SUVs, Congress had limited the Section 179 deduction for SUVs (rated at 14,000 pounds GVW or less) to $25,000, beginning with purchases after October 22, 2004. However, this still provided a substantial deduction - one way in excess of that allowed for a regular passenger vehicle. The current maximum first-year deduction for passenger vehicles is $3,060.

Congress has previously been reluctant to further curtail the SUV write-off for fear of harming the ailing U.S. auto industry.

New Tax Law Expands and Extends the Work Opportunity Tax Credit

Employers can qualify for a tax credit known as the work opportunity tax credit (WOTC) that is worth as much as $2,400 for each eligible employee (higher amounts for certain veterans and other special categories). The credit is available on an elective basis for employers hiring individuals from one or more of nine targeted groups. The amount of the credit available to an employer is determined by the amount of qualified wages paid by the employer. Generally, qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer.

The recent passage of the Small Business and Work Opportunity Tax Act made some significant changes to the provisions of the WOTC:

AMT – The WOTC will offset the Alternative Minimum Tax (AMT).

Extended by 44 Months – The WOTC is extended by 44 months to Aug. 31, 2011 for most targeted groups. Historically, this credit has been renewed by Congress on a temporary or year-by-year basis, and had been scheduled to expire at the end of 2007. More employers may now take advantage of the credit, because they will have more time to include the targeted hirees in their strategic planning. It is effective for individuals who begin work for the employer after May 25, 2007.

High-Risk Youth WOTC – The WOTC requirements are eased for so-called “high-risk youths” who begin work for the employer after May 25, 2007. These changes should especially benefit employers in “rural renewal counties,” which are counties outside of metropolitan areas that had a net population loss in the 1990s.

(1) Substitutes “designated community residents” for “high-risk youths” as a “targeted group,”

(2) Substitutes a definition of a designated community resident for the definition of a high-risk youth by providing that a “designated community resident” is an individual who is certified by the designated local

agency as having attained age 18 but not age 40 on the hiring date, and as having his principal place of abode within an empowerment zone, enterprise zone, renewal community or rural renewal county and

(3) For a designated community resident, wages that qualify for the WOTC don't include wages paid or incurred for services performed while the individual's principal place of abode is outside an empowerment zone, enterprise community, renewal community or rural renewal county.

Expanded "Ticket to Work" – A provision expanding the WOTC to cover "Ticket to Work" plan participants is effective for individuals who begin work for the employer after May 25, 2007. The Act adds, as a third qualifying format, an individual work plan developed and implemented by an employment network with respect to which the requirements of the Social Security Act are met.

Disabled Veterans – The WOTC is enhanced for employing certain disabled veterans who begin work for the employer after May 25, 2007. The Act provides that a "qualified veteran" is an individual who is a veteran and is certified by the designated local agency as:

(1) Meeting the Food Stamp requirement, or

(2) Entitled to compensation for a service-connected disability, and

– Having a hiring date that isn't more than one year after having been discharged or released from active duty in the U.S. Armed Forces, or

– Having aggregate periods of unemployment during the one-year period ending on the hiring date that equal or exceed six months (the compensation-for-disability requirement).

Hardship Withdrawals Liberalized

Generally, it is never a good idea to take distributions from a 401(k)-type plan except for their intended use. These plans were authorized by Congress to provide tax-deferred savings that are intended to provide support for the plan participant when disabled or during post-age 59½ retirement. Although all distributions are taxable, those taken before reaching the age of 59½ are subject to an additional 10% "early distribution" penalty on the taxpayer's federal return and may also be penalized on the state return. Thus, the combination of federal tax, state tax (if applicable) and the early withdrawal penalty can make it very expensive to tap these funds prior to retirement, and taxpayers should first look for other alternatives.

Hardship Withdrawals – However, if the particular plan permits, taxpayers are allowed to take a "hardship" distribution from the plan. Generally a "hardship" distribution is described as a cash withdrawal to satisfy an immediate and heavy financial need of the employee (plan participant) and is necessary to satisfy the financial need. Tax regulations specify the following as distributions on account of an immediate and heavy financial need:

(1) Expenses for medical care that would ordinarily be deductible which includes expenses for the care of a spouse, dependent or primary beneficiary under the plan;

(2) Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);

(3) Payment of tuition, related educational fees, and room and board expenses, for up to the next 12 months of post-secondary education for the employee, or the employee's spouse, children, dependents, or primary beneficiary under the plan;

(4) Payments necessary to prevent the eviction of the employee from the employee's principal residence, or foreclosure on the mortgage on that residence;

(5) Payments for burial or funeral expenses for the employee's deceased parent, spouse, children, dependents or primary beneficiary under the plan; or

(6) Expenses for the repair of damage to the employee's principal residence that would qualify for the casualty deduction.

Caution: Even though hardship withdrawals are allowed, they are still taxable distributions and are subject to the early withdrawal penalty unless they meet certain exceptions.

Medicare-B Premiums Increase Over Three Years

You may have noticed an increase in your Medicare-B premium for 2007. That is only the beginning, since a premium increase is being phased in over a three-year period (2007 through 2009). The Federal Government has been supplementing the Medicare-B insurance premiums for some years, as the costs have exceeded the funds generated from the premiums. Thus, beginning with 2007, the premiums are being increased for higher-income individuals based upon their modified adjusted gross income (AGI) for the year two years prior. For example, in 2007, the modified AGI for 2005 was used.

The adjustment only applies to married taxpayers with an AGI above the threshold amount of $160,000 and others with an AGI above $80,000. The amount of the increase varies from 13.33% to 73.33%, depending how far above the threshold the taxpayer's AGI (income) is. The maximum, 73.33%, applies to married taxpayers with incomes in excess of $400,000, and $200,000 for all others, except married separate individuals living together during the year who pay the maximum once their income exceeds $120,000. The $80,000, $120,000 and $160,000 thresholds will be adjusted annually, in $1,000 increments, based on the Consumer Price Index.

Think the 2007 increase is bad? The government's subsidy of the Medicare-B premium for the affected higher-income taxpayers is being phased out over a three-year period. Thus, based on the same AGI, in 2008, the monthly adjustments will double the 2007 increase based on the 2006 AGI, and the 2009 increase will be triple based on the 2007 AGI.

Research and Development (R&D) Credit Extended

As part of the Tax Relief and Health Care Act of 2006 passed in late December 2006, the research and development (R&D) credit, which expired at the end of 2005 is reinstated retroactively for 2006 and extended through 2007. In addition, for tax years ending after 2006, the new law enhances the credit by:

(1) Increasing the rates of the alternative incremental credit, and

(2) Creates an alternative simplified credit that does not use gross receipts as a factor, thus allowing newer businesses to qualify for the credit.

Although the computation can be more complicated, generally a taxpayer can claim a research credit equal to 20 percent of the business's incremental increases in qualified research expenses.

Expenses qualifying for this credit generally include: (1) in-house wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) sixty-five percent of expenses of research contracted out to others.

New alternative simplified credit – The alternative simplified credit available in tax years after 2006 is equal to 12 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for three preceding taxable years. The rate is reduced to 6 percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years.

Option to deduct R&D expenses – As an alternative, a taxpayer may elect to deduct R&D expenses that do not create an asset or extend an asset's useful life. Where an asset is created, or the life is extended, the expenses must be capitalized. However, deductions allowed to a taxpayer must be reduced by an amount equal to 100 percent of the taxpayer's research tax credit for the taxable year. Taxpayers can alternatively elect to claim a reduced research tax credit amount (13 percent) in lieu of reducing deductions otherwise allowed.

2007 – Last Year for Higher Education Expenses Deduction

Unless extended by Congress before the year's end, 2007 is the final year for the deduction for qualified higher education expenses. Individual taxpayers will be allowed to deduct up to $4,000 of higher education expenses instead of claiming the Hope or Lifetime Learning tax credits. The deduction is taken "above-the-line," so that it is deductible even for those taxpayers who do not itemize their deductions.

Caution: This deduction phases out for higher-income individuals. Married taxpayers filing jointly with an Adjusted Gross Income (AGI) of $130,000 or less are allowed to deduct up to $4,000 of expenses. The maximum deduction drops to $2,000 for taxpayers with an AGI over $130,000, but no deduction is allowed at all if the AGI exceeds $160,000. For other taxpayers, the equivalent AGI limits are $65,000 and $85,000. In addition, taxpayers filing as Married Separate, Dependent of Another or Nonresident Alien are not allowed to take this deduction.

Sales Tax Deduction Slated to End in 2007

Taxpayers who itemize deductions are allowed to deduct the greater of the state income tax or state and local general sales tax paid during the year.

The sales tax deduction is the greater of:

(1) actual state and local sales tax paid based on receipts or

(2) an income-based amount from an IRS-created table, plus the sales tax on certain major nonbusiness purchases (including vehicles).

Currently, the law allowing sales tax to be deducted is scheduled to expire after 2007. So if you are considering making a large purchase, such as a car, within the next year, and your sales tax deduction would exceed your income tax deduction, you may want to accelerate the purchase into 2007 to be able to deduct the sales tax on the purchase. This strategy does not apply to the extent you are taxed by the alternative minimum tax (AMT).

Final Year for Teacher's Expenses

2007 is the final year that the $250 tax deduction for out-of-pocket costs incurred to purchase books, supplies and other classroom equipment by elementary and secondary school teachers and certain other school professionals can be taken "above-the-line," so that it is deductible even for those taxpayers who do not itemize their deductions.

Combat Pay EIC Election Lost After 2007

Without Congressional action, 2007 is the last year that a taxpayer can elect to have excluded combat pay counted as income for purposes of calculating the earned income tax credit (EIC).

Caution: Making this election for EIC purposes may or may not be advantageous. If the taxpayer has earned income below the maximum amount of earned income on which the credit is calculated, including the combat pay will increase the credit amount. On the other hand, if the taxpayer's earned income is already in the phase-out range, electing to include combat pay as earned income will decrease the amount of credit that can be claimed.

One-Year Only Deduction – Mortgage Insurance Premiums

For the 2007 tax year only, the Act establishes an itemized deduction for the cost of premiums for mortgage insurance on a qualified personal residence for amounts paid or accrued after December 31, 2006 and before January 1, 2008, and that aren't allocable to any period after 2007. The deduction applies only to mortgage insurance contracts issued in 2007, so premiums paid on mortgage insurance for homes purchased before 2007 don't qualify. The deduction is phased-out ratably by 10% for each $1,000 by which the taxpayer's adjusted gross income exceeds $100,000.

New Refundable Minimum Tax Credit Provision

If you were unfortunate enough to have been affected by the alternative minimum tax (AMT) in a prior year, then you may have a carryover of unused minimum tax credit. This primarily applies to taxpayers who exercised qualified (incentive) stock options and held the stock to qualify for long-term capital gains. Up till now, the prior year AMT credit could only be used to the extent that the regular tax exceeded the AMT for the current year. That, in effect, made the credit useless for taxpayers who are perpetually taxed by the AMT.

However, a new law provision taking effect in 2007, and continuing through 2012, allows taxpayers to use a portion of the taxpayer's minimum tax credit carryover that is attributable to the 4th prior year or older (long-term unused minimum tax credit) in the current year, even if taxed by the AMT in the current year. The amount that is refundable is limited to the greater of:

(1) the lesser of:

a. $5,000 or

b. the long-term unused minimum tax credit, or

(2) 20% of the long-term unused minimum tax credit.

As if it wasn't complicated enough, the AMT refundable credit amount is also reduced by 2% for each $2,500, or part of $2,500 ($1,250 for married filing separately), that the taxpayer's AGI exceeds the annual inflation adjusted limit for the taxpayer's filing status. For 2007, those amounts are:

Single	Head of Household	Joint (SS)	Married Separate
$156,400	$195,500	$234,600	$117,300

If the AGI exceeds the amount shown by more than $122,500 ($61,250 if married filing separately), the amount allowed for the refundable AMT credit is reduced to zero.

DISCLAIMER

The purpose of this guide is to provide current information on tax, financial and business developments and to suggest general tax planning ideas that may be appropriate in certain situations. It suggests general tax planning ideas that may only be appropriate when claiming tax benefits in a manner consistent with the statutes and Congressional purpose. The information and opinions are generalizations and may not apply to all taxpayers and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer. Therefore, it is important that you seek appropriate advice before implementing any of the ideas suggested.

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